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*By Eileen M. Newell**

INTRODUCTION

Numerous organizations operate hospitals, clinics or associations, bringing all aspects of healthcare to a broad sector of the community.[1] Hundreds of these entities operate hospitals as nonprofit entities, on a tax-exempt basis,[2] usually providing, at a minimum, emergency care to the entire community regardless of an individual's ability to pay.[3] In addition, countless organizations and associations provide research and education in the healthcare field. While healthcare organizations are not the only classification of tax-exempt organizations,[4] healthcare providers are at an

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1. In 1997, the National Taxonomy of Exempt Entities ("NTEE") classified nearly sixteen percent of all nonprofit charitable organizations as health organizations. These health entities, collectively reported assets and revenue totaling in value of $506,640,000,000 and $395,165,000,000. *See* Paul Arnsberger, *Charities and Other Tax-Exempt Organizations, 1997,* STATISTICS OF INCOME BULL. 50 (2000).

2. To encourage the operation of certain activities that benefit the community, the Internal Revenue Code provides for exemption from income tax on income generated from designated exempt activities. *See* I.R.C. § 501 (West 2000).

3. *See* Rev. Rul. 69-545, 1969-2C.B. 111. However, an emergency room is not an absolute requirement for tax exemption. *See also* Rev. Rul. 83-157, 1983-2 C.B. 94, stating that the lack of an emergency room would not preclude the eligibility for tax-exempt status if an emergency room would be unpractical because the specialized nature of certain hospitals.

4. The NTEE breaks down the Nonprofit Charitable Organization sector into ten categories: (1) arts, culture, and humanities; (2) education; (3) environment,

increased risk of losing the exempt status, due to the high-profile nature of its industry.[5] Undoubtedly, the laws regarding nonprofit organizations and the tax-exempt status,[6] which may or may not be granted to a nonprofit organization, have a tremendous impact on the administration of healthcare.

Often, a nonprofit organization is willing to contract with a for-profit entity in order to generate the funding necessary to provide healthcare to the community.[7] In such a relationship, for-profit organizations are attempting to decrease costs and increase revenue, which ultimately provides a greater rate of return for investors. Regardless of the entity's philosophy behind offering its services, healthcare providers try to find the most efficient and effective means to operate their facilities. As a result, new combinations of joint ventures and alliances between nonprofit and for-profit entities emerge, commonly in the form of a

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animals; (4) health; (5) human services; (6) international, foreign affairs; (7) mutual, membership benefit; (8) public, societal benefit; (9) religion related; and (10) unknown, unclassified. *See* Arnsberger, *supra* note 1, at 50.

5. *See* THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS §1.1 (John Wiley & Sons 1995).

6. While these two terms, "nonprofit" and "tax-exempt", are used as synonyms, a difference does exist. The term "nonprofit" generally refers to section of the state law in which an organization seeks incorporation. Almost all states have enacted a form of nonprofit corporate law. *See* JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 64 (2d ed. 2000). The term "tax-exempt" deals specifically with organizations that have received an exemption from a form of taxation by federal and state officials. Although most tax-exempt organizations incorporate as nonprofits, a nonprofit is not automatically tax-exempt. To gain tax-exempt status for federal income tax purposes under I.R.C. §501, an organization must file Form 1023 with the Internal Revenue Service. *See* I.R.S. Publication 557 (Rev. July 2001), *Tax-Exempt Status for Your Organization*, Cat. No. 46573C, 2.

7. Additional and more specific reasons for a nonprofit to enter into a joint-venture include:

> [T]o grant physicians a stake in a new enterprise or service. . .; to bring a new service or medical facility to a needy area; to share the risk that is inherent in anew enterprise; to pool diverse areas of medical expertise; to attract new patient admissions and referrals; to persuade physicians not to refer patient elsewhere; and to ensure that physicians do not establish a competing healthcare provider.

See MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS 5 (John Wiley & Sons 2000).

partnership or a limited liability company (LLC).[8]

Initially, the Internal Revenue Service[9] was hesitant to allow these agreements, fearing it would compromise the integrity of the tax-exempt status.[10] After realizing the prohibition on these ventures was hindering the success of nonprofit entities in the world of big business, the Service reconsidered its position.[11] Consequently, nonprofit hospitals and clinics began to form partnerships to survive in the world of managed healthcare. The structures of these ventures have taken various forms, including "whole hospital" and "ancillary" joint ventures.[12] With recent holdings by the IRS and the courts, the boundaries of these ventures are only now being determined; thus, providing uncertainty to those who wish to enter into these agreements.

This Comment addresses the effect of joint ventures on the tax-exempt status of nonprofit healthcare entities.[13] Section I provides an overview of the requirements for tax-exemption, as laid out in the Internal Revenue Code (IRC). Section II discusses the reluctance of the IRS to permit exempt organizations to enter into joint ventures with non-exempt entities. Section II then summarizes the brief, but controversial, history of joint ventures. Section III gives a detailed analysis of common healthcare joint ventures. Section IV addresses the recent attempts to limit joint

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8. Even though partnerships and limited liability companies (LLCs) are treated as flow-through entities for tax purposes, the LLC may be a more attractive option, since the investor is not personally liable for the actions of the LLC. Similar to a corporation, the investor is only liable for the actions of the LLC up to the amount invested. *See* UNIF. LTD. LIAB. CO. ACT §303 (1996).

9. The Internal Revenue Service will be referred to as "IRS" or "The Service."

10. The IRS serves as guardian on behalf of the community for assets that are donated to charitable organizations.

11. *See* Off. Mem. 19225, EE-7-80 (Mar. 13, 1980). *See also* Gen. Couns. Mem. 39,005 (June 28, 1983).

12. These types of joint ventures will be discussed in detail in Section III of this article.

13. While this Comment deals only with the tax exemption granted by the Internal Revenue Service, an exempt organization should also examine the treatment of joint ventures with for-profit entities by state and local governments. The state and local governments provide tax exemption to a qualifying nonprofit for taxes they impose, such as, but not limited to property tax and state income tax. *See generally* Kenneth D. Chestek, *Are Hospitals Purely Public Charities?*, 7 ASSESSMENT J. 2 (2000).

ventures, thus affecting the ability of nonprofit and healthcare organizations to remain competitive in the industry.

I. TAX-EXEMPTION FOR HEALTHCARE PROVIDERS

Section 501(c)(3) of the IRC provides an exemption from federal income tax for organizations that promote a charitable, scientific or educational purpose.[14] From the initial enactment of this section, hospitals have been viewed as traditional charities and have qualified for the exemption.[15] In the Nineteenth Century, the wealthy enjoyed the luxury of a "house-call" from the local physician, who generally worked out of the home.[16] For the less fortunate, hospitals provided health services when the wages of a private physician could not be paid.[17] The generosity and benevolence of charitable donors funded hospitals.[18] Unfortunately, hospitals were not known for providing extensive medical services. In many cases, the hospital was a place to provide comfort for those sick and close to death.[19] However, the indigent had no other alternative.

As medical technology developed during the Twentieth Century, so did the need for collective resources.[20] Physicians turned to hospitals as a way to share equipment and human resources. Consequently, hospitals evolved into the primary location for healthcare.[21] Since many physicians moved their practices to hospitals, patients were expected to pay for hospital services, even in charitable hospitals. Regardless of this change, hospitals have generally continued to provide some level of care to those who can not afford it.[22]

Medical technology and practices were not alone in this evolutionary process. Notably, the ideological concept of charity was transformed from

14. I.R.C. § 501(c)(3) (1994).

15. JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 384 (2d ed. 2000).

16. *See generally* Chestek, *supra* note 13, at 24.

17. *See id.*

18. *See id.*

19. *See id.*

20. *See generally* Chestek, *supra* note 13, at 24.

21. *See Id.*

22. *See* Rev. Rul. 69-545, 1969-2 C.B. 111, *supra* note 3.

"relief of the poor"[23] to "community benefit."[24] Yet, throughout this change, the idea of providing healthcare services as a form of charity went unquestioned. In the general law of charity, the promotion of health is considered a charitable purpose.[25] Clearly satisfying the exempt purpose requirement, a healthcare provider must also meet the other requirements outlined in Section 501(c)(3) in order to receive and maintain the exempt status.[26]

In addition to merely having an exempt purpose, the organization's primary activities must be designed to accomplish that purpose.[27] Therefore, exempt entities must be "[o]rganized and operate exclusively" so that the public or charitable interest prevails over any private interest.[28] The assets of the organization must be substantially used to further the charitable purpose. Thus, an exempt healthcare provider must conduct a substantial portion of its business activities to provide a benefit to the community, which in this case is the promotion of health.

Another requirement for tax exemption under the Code is that no private shareholder or individual may inure a benefit[29] from the organization's net earnings.[30] A "private shareholder or individual" is a person having a personal and private interest in the activities of the organization.[31] If an exempt organization violates the private benefit or

23. *See* Rev. Rul. 56-185, 1969-2 C.B. 202. An organization's ability to provide relief to the poor is a key factor in determining its tax-exempt status.

24. During this time, Medicare and Medicaid programs commenced, greatly affecting the healthcare industry and the role of the government and charities as providers. *See also* Eastern Kentucky Welfare Rights Organization v. Simon, 506 F.2d 1278 (1974); SANDERS, *supra* note 7, at 329; Gen. Couns. Mem. 39,862 (Nov. 21, 1991).

25. *See* RESTATEMENT (SECOND) TRUSTS, §§ 368, 372 (1957).

26. *See* Rev. Rul. 69-545, 1969-2 C.B. 117.

27. Treas. Reg. §1.501(c)(3)-1(c)(1) (1986).

28. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii) (1986).

29. "Private inurement" is an impressible transaction involving an individual inside the organization, such as a director, manager or any related party receiving assets from the organization in anything less than an arm's length transaction. *See* United Cancer Council v. Comm'r, 165 F.3d 1173 (7th Cir. 1999). "Private benefit" is the term used when an exempt organization operates substantially to benefit outside private interest. *See generally* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989).

30. *See* I.R.C. § 501(c)(3)(e) (2001).

31. *See* Treas. Reg. §1.501(a)-(1)(c) (2001).

private inurement restriction, its tax-exempt status may be revoked.[32]

Joint ventures bring additional attention to the possibility of exempt healthcare providers violating this prohibition. "The private inurement doctrine forbids ways of causing income or assets of a healthcare organization from flowing away from the organization and to or for the benefit of one or more persons with some significant relationship to the organization."[33] If a joint venture is not carefully structured between a for-profit entity and an exempt entity,[34] the actions of the exempt organization may be providing additional benefits to a private individual,[35] including but not limited to the for-profit entity and its officers and directors.

As the demand for providing quality healthcare at lower costs increases, healthcare providers are turning to large-scale operations in the hopes of meeting this demand, while still maintaining a stable financial situation. Joint ventures provide a common solution to the economic and fiscal problems faced by both for-profit and nonprofit entities. The agreements between these two organizations must satisfy both the desire and expectation of income by the for-profit investors and the requirements laid out in Section 501(c)(3) for the benefit of the nonprofit entity.

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32. *See* Ancolte Psychiatric Ctr. v. Comm'r, 98 T.C. 374 (1992). The IRS may impose an excise tax in addition to or in place of the revocation of the exempt status. Under the IRC, "intermediate sanctions" are imposed on organizations that engage in and its managers who authorize an excess benefit transaction. The Intermediate sanctions can be very steep. Persons who engage in these prohibited activities with a § 501(c)(3) organization are taxed on twenty-five percent of the amount of the excess benefit received. This tax may increase to two hundred percent if the transaction is not corrected. A manager is subject to a ten percent tax, if he authorizes a transaction that he knows is an excess benefit transaction. *See* I.R.C. § 4958(a)(1)-(2), (b).

33. HYATT & HOPKINS, *supra* note 5, §4.1, at 56.

34. An exempt organization participating in a joint venture may be engaging in private inurement if the for-profit partner receives additional compensation or allocations of the profits, e.g., if a physician receives a reduced rental rate, or if a hospital does not receive adequate consideration on the sale of its assets. This list is not exhaustive. *See* SANDERS, *supra* note 7, at 342.

35. Gen. Couns. Mem. 39,862 (Nov. 21, 1991). "The inurement prohibition serves to prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use." *Id.*

II. THE EVOLUTION OF NONPROFIT JOINT VENTURES

Prior to 1982, the IRS prohibited nonprofit entities from entering into an agreement with for-profit entities.[36] This per se incompatibility rule was reasoned on two principles.[37] First, the maximization of the financial interests of the for-profit partners would be viewed as the primary motivation driving the nonprofit's actions, because the nonprofit has a legal duty to do so, serving as a general partner.[38] Hence, the organization would be in direct violation of Section 501(c)(3), which requires exclusive operation in furtherance of its exempt purpose.[39] Second, the mere fact that a for-profit entity would share in the net-profits of a joint venture's activities is in violation of the prohibition of inuring private benefit.[40] Without a prevailing charitable purpose, the organization would lose its tax exemption.

Furthermore, the exempt organization would be serving as a general partner in the joint venture. Because a general partner is exposed to unlimited liability, not only is the investment in the joint venture at risk, but also all of the assets of the exempt organization.[41] This additional exposure accentuates the concern of the IRS, the donors of the assets,[42] and the community at large.

If an exempt organization does not want to assume the risks that accompany a general partner, it can invest as either a limited partner or a non-managing investor.[43] In this role, the exempt organization does not have a fiduciary obligation to the for-profit partners and does not risk

36. *See generally* Plumstead Theatre Society v. Comm'r, 74 T.C. 1324 (1980), *aff'd,* 675 F.2d 244 (9th Cir. 1982). The Tax Court found that a tax-exempt organization serving as a general partner was " no more intrusive or indicative of private interests than [a] contractual percentage arrangement." *Id.* at 1334.

37. David M. Flynn, *Tax Court's Decision in Redlands Provides Limited Endorsement for IRS Position on Joint Ventures*, 91 J. TAX'N 241 (1999).

38. *See id* at 242.

39. *See* Gen. Couns. Mem. 36,293 (May 30, 1975).

40. *See* Flynn, *supra* note 37, at 241.

41. *See* REV. UNIF. PARTNERSHIP ACT §306 (1997); *See also* UNIF. LTD. PARTNERSHIP ACT §§303, 403 (1976 as amended 1985).

42. A taxpayer may deduct charitable contributions donated to organizations, which are granted exemption under Section 501(c)(3). See I.R.C. § 170 (2001).

43. *See generally* Michael Sanders, *New Horizon for Nonprofits: How to Structure Joint Ventures with For-Profits*, BUS. L. TODAY, Aug. 9, 2000, at 53.

unlimited exposure of its assets.[44] An exempt organization may invest in a partnership that does not advance its charitable purpose as long as the interest is "insubstantial" to the exempt organization's overall investments or activities.[45] If the activity does not relate to the organization's exempt purpose, the organization may be obligated to pay tax on any income received.[46] While it is possible for an exempt organization to be a limited partner in a joint venture, additional uncertainty arises when the exempt organization is a general partner.

A. Permissibility of Joint Ventures

When the Ninth Circuit affirmed the Tax Court's holding in *Plumstead Theatre Society v. Commissioner*,[47] the IRS was forced to reconsider its absolute ban on joint ventures.[48] In *Plumstead*, difficulties in raising funds for its exempt activities caused a nonprofit theater company to enter into a limited partnership as the general partner with several for-profit investors that were serving as limited partners.[49] The limited partners had the majority share of the net earnings, but this detail had no impact on the court's holding.[50] The court was convinced that the transaction was performed at arm's length and was no more incurring a private benefit than contractual percentage agreements previously approved by the courts.[51] Ultimately, the theatre company's control over the activities of the joint venture became the factor that allowed joint ventures to occur. "The limited partners have no control over the way [the nonprofit] operates or manages its affairs, and none of the limited partners . . . is an officer or director of the [charitable organization]."[52] Although the facts of *Plumstead* involve a theater company, the holding can be applied to the

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44. *See id.*

45. *See* I.R.C. § 513; Treas. Reg. § 1.513-1(d)(2) (2001).

46. *See* I.R.C. § 511(a)(1); Treas. Reg. § 1.511-1 (2001). A tax-exempt entity has an obligation to pay tax on income that is generated from an activity that is unrelated to its exempt purpose. This tax is commonly known as unrelated business income tax (UBIT).

47. *See* Plumstead, 74 T.C. 1324.

48. *Id.*

49. *Id.*

50. *See id.* at 1328.

51. *See id.* at 1334, (*citing* Broadway Theatre League of Lynchburg, Va. v. United States., 293 F.Supp. 346 (W.D.Va.1968)).

52. *See id.*

structures of all joint ventures entered into by exempt organizations, including healthcare entities. If a nonprofit entity is able to dictate that the activities of the joint venture be charitable, a for-profit investment in the capital accounts should be merely incidental to the 501(c)(3) status.

B. Facts and Circumstance Test

As a result of the court's holding in *Plumstead*, the Service adopted a fact and circumstance analysis of the newly forming joint ventures. The analysis is based on a two-prong test.[53] First, the activities of the partnership must be in furtherance of the tax-exempt purpose.[54] A nonprofit entity must continue to earn its tax-exempt status by conducting activities that benefit the community. The tax-exemption is not in jeopardy solely because an organization distributes a portion of its profits to private investors. The second prong examines the exempt organization's flexibility in the partnership agreement to operate exclusively in furtherance of its charitable purpose.[55] Through this prong, the IRS determines the impact of the exempt organization's control over the activities of its ventures and the extent of the inurement to private investors.

This new approach to nonprofit and for-profit business agreements changed the structure of healthcare organizations. Through the issuance of a series of private letter rulings and general counsel memoranda, the IRS has permitted these agreements in either partnerships or other forms of joint ventures involving numerous healthcare related activities. An ambulatory surgical center, a substance abuse treatment center, magnetic resonance imaging (MRI) services, an acute medical rehabilitation hospital, a gastroenterology laboratory and a kidney dialysis and treatment center were just some of the business entities that emerged as a result of for-profit and nonprofit participation.[56]

In 1992, the IRS published examination guidelines to be used by agents

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53. *See* Gen. Couns. Mem. 39,005 (June 28, 1983).

54. *Id.*

55. *See id.*

56. *See* Priv. Ltr. Rul. 94-07-022 (Nov. 22, 1993); Priv. Ltr. Rul. 88-17-039 (Jan. 29, 1988); Priv. Ltr. Rul. 85-21-055 (Feb. 26, 1984); Priv. Ltr. Rul. 88-33-038 (May 20, 1988); Priv. Ltr. Rul. 93-52-030 (Oct. 08, 1993); Priv. Ltr. Rul. 93-08-034 (Nov. 30, 1992); Priv. Ltr. Rul. 91-05-029 (Nov. 06, 1990); Priv. Ltr. Rul. 88-33-038 (May 20, 1988); Priv. Ltr. Rul. 90-35-072 (June 07, 1990); Priv. Ltr. Rul. 88-20-093 (Feb. 26, 1988); Priv. Ltr. Rul. 87-05-089 (Nov. 07, 1986).

during hospital audits to determine if the organization is meeting both the community benefit standard and limiting the private inurement.[57] In serving the community, hospitals should have the following attributes: (1) an "open staff policy"; (2) a full-time emergency room open to everyone;[58] (3) acceptance of Medicare and Medicaid; (4) availability of non-emergency services; and (5) overall community involvement.[59] According to the IRS, these five policies that may be implemented by a healthcare provider are the favorable factors needed to satisfy the first prong of the facts and circumstance test.

The guidelines also included the following factors that would indicate private benefits: (1) research obligations benefiting the private parties and not the public; (2) "excessive compensation"; (3) "loan agreements at less than prevailing interest rates;" and (4) "supplies or services are provided . . . at preferred terms" by the charitable organization.[60] These situations give a for-profit investor benefits from the activities performed by the nonprofit partner. The question remains as to what extent these factors must be met.

C. Need for Control

After implementing the facts and circumstance test, the IRS consented to joint ventures between nonprofit and for-profit entities. *Housing Pioneers v. Commissioner*[61] marks the first limitation to the IRS condoned joint ventures. In *Housing Pioneers*, the charitable healthcare organization participated as a one percent general partner in a limited partnership with for-profit investors.[62] The court never reached the analysis regarding the second prong of the test, the control of the agreement, because the agreement never passed the first prong.[63] The agreement failed, "because its proposed activities included at least one

57. *See* IRS Exempt Organization Examination Guidelines for Hospitals, Ann 92-83, 1992-22 I.R.B. 59. §333 (June 1, 1992).

58. An open emergency room is not required but often helps. *See id.* and *see also* Rev. Rul. 83-157, 1983-2 C.B. 94.

59. *See* IRS Exempt Organization Examination Guidelines for Hospitals at §333.1.

60. *See id.* at §333.2.

61. *See* Housing Pioneers v. Comm'r, 65 T.C.M. 2191 (1993), *aff'd*, 49 F.3d 1995, *amended by* 58 F.3d 401 (9th Cir. 1995).

62. *See* Housing Pioneers v. Comm'r, 58 F.3d 401, 403 (9th Cir. 1995).

63. *See id.*

non-exempt purpose which was 'substantial in nature.'"[64] While this case may seem irrelevant to healthcare organizations, which traditionally have provided charitable services, the holding allowed the IRS to switch its focus from the first prong to scrutinizing the factors of the second prong of the facts and circumstance test.

Within three years, the IRS began to examine the need for control in two private letter rulings regarding healthcare providers.[65] In the first, the IRS was content with the purchase of a 62.5 percent interest in a LLC by two exempt healthcare organizations[66] because physicians, who did not serve as officers or directors in either organization, owned the remaining interest.[67] The purchasing agreement called for an arm's length transaction and proportionate allocations of the LLC 's earnings and liability.[68] In addition, the LLC had policies and guidelines for the operation of the outpatient dialysis center, which constituted its business activity.[69]

In the second letter ruling, however, the IRS had some concern with the nonprofit's lack of control as provided in the partnership agreement.[70] The organizations agreed to amend the agreement, which gave the charity substantive authority and revoked a security agreement, thus compromising the prohibition on private inurement.[71] After these changes the exempt status was no longer in danger.[72]

Through the release of private letter rulings[73] and audit guidelines, the IRS has continually expressed the importance of the exempt organization's ability to control the activities of any venture in which the assets of the charity are invested. This is especially true when the exempt

64. *Id.* at 402.

65. *See* Priv. Ltr. Rul. 96-37-050 (June 18, 1996); Priv. Ltr. Rul. 97-36-039 (June 9, 1997).

66. *See* Priv. Ltr. Rul. 96-37-050 (June 18, 1996).

67. *Id.*

68. *Id.*

69. *Id.*

70. Priv. Ltr. Rul. 97-36-039 (June 9, 1997).

71. *See id.*

72. *See id.*

73. The IRS is bound only to the holding in the Private Letter Rulings for the individual to whom the ruling was issued. While private letter rulings may not be cited as authoritative, these letter rulings provide an understanding to the IRS's position on a certain issue. *See* I.R.C. § 6110 (k)(3) (2001).

organization serves as the general partner in a newly formed partnership[74] or the managing member of a LLC.

III. DETAILED ANALYSIS OF COMMON HOSPITAL JOINT VENTURES

Joint ventures have been common place among healthcare-providing entities. "Because the healthcare sector of the economy has been the most dynamic area involving [exempt organizations] on a large scale, many of the new and different types of joint venture transactions have involved tax-exempt healthcare organizations."[75] To understand fully the nonprofit's ability to control the organization, the structural details of a particular transaction can be a significant factor in the IRS's future ruling. "Whole-hospital joint ventures," as indicated by the number of requests for private letter rulings received by the IRS,[76] and "ancillary joint ventures" have emerged as popular arrangements for the joint ventures.

A. Whole Hospital Joint Ventures

In a whole hospital joint venture, the exempt entity is able to contribute its assets to the joint venture, provided its goal is to further the tax-exempt purpose of the entity.[77] In many cases, the hospital's assets will be transferred to the newly formed entity. The for-profit organization manages the day-to-day operations of the venture,[78] while the nonprofit does not take part in healthcare services. However, the nonprofit entity does receive distributions based on its percentage of ownership in the venture.[79] The nonprofit organization contributes additional capital to ensure the performance of the charitable healthcare aims.[80] The nonprofit maneuvers its assets to further its tax-exempt purpose through its positions on the board of directors of the newly formed venture. The for-profit organization receives assets necessary to run a hospital at a

74. *See* discussion *supra* Section II.

75. Flynn, *supra* note 37, at 242.

76. *See id.*

77. *See* THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX EXEMPT HEALTHCARE ORGANIZATIONS, 2000 CUMULATIVE SUPPLEMENT 104 (John Wiley & Sons, Inc. 2000).

78. *See id.*

79. *See id.*

80. *Id.*

reasonable rate of return.[81] A whole hospital joint venture can be a beneficial vehicle to the success of both the for-profit and nonprofit entities.

The IRS addressed the whole hospital venture in Revenue Ruling 98-15.[82] This was only the second revenue ruling issued addressing healthcare entities since 1986.[83]

Consistent with the fact-and-circumstance analysis that emerged in this area, the ruling is comprised of two joint venture scenarios.[84] The first situation describes an agreement that meets the IRS expectations for a joint venture under § 501(c)(3).[85] The agreement described in the second situation falls short of satisfying the expectations of the IRS.[86] If an organization has facts synonymous with either situation described in the ruling, then the maintenance or revocation of its tax-exempt status can be easily inferred. However, uncertainty arises when the fact patterns fall somewhere in the middle.[87]

The two proposed situations begin with similar fact patterns. A tax-exempt hospital forms a LLC with a for-profit corporation in the hopes of obtaining additional funding to serve the community.[88] To do so, the nonprofit contributes its hospital assets and other operating assets in return for an ownership interest proportional and equal to the contribution in the newly formed LLC.[89] A for-profit entity, willing to finance the hospital, expects to earn a reasonable rate of return on its investment. It also contributes assets in exchange for a proportional and equal interest.[90] The earnings and distribution of the LLC are made in proportion to the ownership interests.[91] The nonprofit agrees to award grants to promote the health of the community, including healthcare to those that cannot afford it, with the profit it receives from the joint

81. *Id.*

82. *See generally* Rev. Rul. 98-15, 1998-1 C.B. 718.

83. *See* HYATT & HOPKINS, *supra* note 77, at 104-105.

84. *See* Rev. Rul. 98-15, 1998-1 C.B. 718.

85. *See id.*

86. *See id.*

87. *See* HYATT & HOPKINS, *supra* note 77, at 110.

88. *See* Rev. Rul. 98-15, 1998-1 C.B. 718.

89. *See id.*

90. *See id.*

91. *Id.* at 719.

venture.[92] The legal and financial arrangement, stated above, is common to both situations found in the ruling.[93]

In contrast, discrepancies exist between the two situations, which are significant enough to warrant revocation of tax-exempt status. The difference appears in three areas: governance, management, and decision-making authority.[94] While the board of governance shall consist of both for-profit and nonprofit appointees in both scenarios, the significant factor is the number of governors each owner can appoint.[95] In situation one, the governing board consists of three individuals chosen by the nonprofit partner and two individuals chosen by the for-profit partner.[96] The nonprofit has an outright majority of the board. In situation two, the governing board consists of three delegates from each owner.[97] "Because [the nonprofit] will share control of [the LLC] with [the for-profit], [the nonprofit] will not be able to initiate programs within [the joint venture] without the agreement of at least one governing board member appointed by [the for-profit]."[98] Convinced that the for-profit entity will put its business enterprise before the tax-exempt purpose, the Service held the structure of the board threatened the "furtherance of an exempt purpose" requirement.[99]

In situation two, presented with an equal number of board members from or appointed by each partner, the tax-exempt organization has the authority to strike down any provisions asserted by its for-profit counterparts.[100] However, the nonprofit does not maintain enough control because "a majority controlled board can initiate actions in furtherance of the charitable purpose while an evenly divided board cannot."[101] The requirement of a ratio in favor of the exempt organization indicates the

92. *See id.*

93. *See* Douglas M. Mancino, *New Ruling Provides Guidance, Raises Questions for Joint Ventures Involving Exempt Organizations*, 88 J. TAX'N 294 (1998).

94. *See id.*

95. *See generally* Rev. Rul. 98-15, 1998-1 C.B. 718.

96. *See id.*

97. *See id.*

98. *Id.*

99. *Id.*

100. *See generally* Rev. Rul. 98-15, 1998-1 C.B. 718.

101. Bruce John Shih & Daniel K. Settlemayer, *Joint Ventures Rev. Rul. 98-15: Don't Apply Blindly*, 10 HEALTH L. 8, 12 (1998).

importance in ensuring that the joint venture will exist to provide community benefit and not private gain.

In both situations, the day-to-day management of the LLC will be determined through a management agreement.[102] In situation one, the contracting company cannot be related to either owner, and the ability to renew the contract is done only with mutual consent of both owners.[103] However, the management agreement in situation two is somewhat different. Instead of an arm's length agreement, a subsidiary of the for-profit entity provides the day-to-day operations of the LLC.[104] Furthermore, the "renewal" provision places the discretion in the hands of the subsidiary.[105]

The Service contends that control is to be a deciding factor throughout the entire structure of the organization. Thus, the actual operation of the joint venture, in addition to the board of governance, must be controlled by the nonprofit.[106] The charitable purpose must be the primary motivation behind the actions of the LLC.[107] To be sure that the operating management contributes to this purpose, the nonprofit must have the capability to control the management company.[108] Control in this sense can be determined through factors such as the independence of the company,[109] the ability to remove the company for cause and the length of the contract.[110] The greater the control, the more secure the exempt status will be.

The decision-making authority of the first LLC is limited in several capacities. First, the governing documents explicitly demand that the LLC operates its hospitals to further the "charitable purpose by promoting health for a broad cross section of the community."[111] Second,

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102. *See* Rev. Rul. 98-15, 1998-1 C.B. 718.

103. *See id.*

104. *See id.*

105. *See id.*

106. *See generally* Michael I. Sanders, *New Horizon for Nonprofits*, BUS. L. TODAY, Aug. 9, 2000 at 53.

107. Treas. Reg. § 1.501(c)(3)-(1)(c)(1) (1986).

108. *See* Rev. Rul. 98-15, 1998-1 C.B. 718.

109. The Service, presumably, would not have any problem if the management company was related to the nonprofit.

110. In the second situation, the contract would run for ten years before the nonprofit would have the chance to exert any substantive influence.

111. Rev. Rul. 98-15, 1998-1 C.B. 718.

this duty to the community prevails over the duty to the owners regarding financial returns.[112] Without the former provision, the "[LLC] will be able to deny care to segments of the community, such as the indigent."[113] This latter provision directly confronts the concern regarding a duty to increase profits for the investors that the Service expressed in *Plumstead*.[114]

Furthermore, the decisions that must be handled by the board of governance, not the management company, are limited in the second situation. Both situations require approval by the board for budgets, distributions of earnings and the selection of key executives. However, the first situation requires that any acquisition or distribution of facilities, contracts above a certain dollar amount and changes to the services offered be presented before the board of governance,[115] thereby providing the nonprofit with additional control of the management company and the activities of the organization. While the second situation includes a provision for the board to decide "unusually large contracts," uncertainty arises as to which contracts actually meet that requirement.[116]

The relevant facts and circumstances outlined in Revenue Ruling 98-15 will give nonprofit entities some guidance as to "participation in [a] partnership [that] furthers a charitable purpose, and . . . permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners."[117] However, guidance is not provided for factual patterns that fall between these two scenarios.

B. Ancillary Joint Ventures

Generally, ancillary joint ventures are not as complex as whole hospital joint ventures. In this type of venture, a nonprofit entity transfers assets to be used in the newly formed healthcare facility, or contributes funds for its establishment.[118] While the nonprofit retains other assets to operate

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112. *See id.*

113. *Id.* at 721.

114. *See* Plumstead Theatre Society v. Commissioner, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

115. Rev. Rul. 98-15, 1998-1 C.B. 718, 721.

116. *See id.*

117. Rev. Rul. 98-15, 1998-1 C.B. 718 (citing *Plumstead*, 74 T.C. 1324, and Housing Pioneers v. Commissioner, 65 T.C.M. 2191 (1993)).

118. *See* FISHMAN & SCHWARZ, *supra* note 15, at 494.

other healthcare facilities,[119] the for-profit maintains the same role as in a whole-hospital joint venture. The for-profit investor merely contributes cash equal to the nonprofit's asset contributions.[120] With an ancillary joint venture, the nonprofit's activities do not focus on the joint venture. "[T]he activity conducted by the exempt organization through the joint venture arrangement is generally not the sole activity of the exempt organization, and it may not be a substantial part of the organization's activities."[121] The nonprofit does not deposit all of its assets into the newly formed entity and it maintains an additional outlet to conduct activities in furtherance of its exempt purpose.

In *Redlands Surgical Services v. Commissioner*,[122] a tax-exempt hospital, Redland Health Systems, created a wholly-owned subsidiary that entered into a general partnership with a for-profit entity.[123] The general partnership owned an interest as general partner in a limited partnership that operated an ambulatory surgical center. In summary, the subsidiary of the tax-exempt hospital "owned 46 percent[124] of a 61 percent[125] interest in an ambulatory surgical center."[126] The subsidiary served merely as a shell to hold the joint venture for the hospital. The only asset the subsidiary held was an interest in the surgical center; likewise, the surgical center was the subsidiary's only source of income.[127] Furthermore, the hospital's president performed double duties as the president of the subsidiary.[128]

The court examined the claim under a fact and circumstances analysis

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119. *See id.*

120. *See id.*

121. *See id.*

122. Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999).

123. *Id.* at 48. The subsidiary, Redlands Surgical Services, was formed to enter the general partnership, in the hopes of limiting the liability exposure.

124. *Id.* at 50. SCA Centers, a publicly traded, for-profit entity, owned the remaining fifty-four percent interest.

125. *Id.* at 49. The remaining thirty-nine percent of the limited partnership was owned by Inland Surgery Center Limited Partnership, an entity consisting of thirty partners who were physicians on the staff of Redlands Hospital.

126. Stanley G. Andeel, *Techniques in Forming and Representing Physician/Business Joint Venture*, SE66 ALI-ABA 199, 228, Feb. 17, 2000.

127. *See Redlands*, 113 T.C. at 65.

128. *Id.*

and denied the organization's petition for tax-exempt status.[129] The lack of an obligation toward a charitable purpose by the general partnership discouraged the court from issuing a favorable holding for the joint venture.[130] In addition, the joint venture failed to give the nonprofit the ability to control the voting power or any other device that would ensure furtherance of the charitable purpose.[131] Similar to situation two in Revenue Ruling 98-15,[132] the day-to-day operations were controlled by the for-profit partner.[133] Finally, the agreement between the for-profit and nonprofit contained competitive restrictions and market advantages that indicated a profit-making agenda and not a community benefit.[134] As the court stated, "[it] is difficult to conceive of a significant charitable purpose that would be furthered by such [restrictions]."[135] Specifically, the court indicated that no factor was determinative, holding that: "Taken in their totality, these factors compel the conclusion that . . . [the charitable organization] impermissibly serves private interests."[136] Conclusively, the totality of the circumstances was the key factor in the court deciding that the organization never held itself out as charitable.[137]

While Revenue Ruling 98-15 is only enforceable upon whole hospital arrangements[138] and the *Redlands* Case has a direct impact on ancillary ventures,[139] the two recent developments can be taken together to examine the Service's and the courts' position on the future of tax-exemption in the healthcare arena.[140]

CONCLUSION

For the past twenty years, the tax-exemption law has reflected an

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129. *See id.*

130. *See id.* at 78-79.

131. *See id* at 79.

132. *See* Rev. Rul. 98-15, 1998-1 C.B. 718.

133. *See Redlands*, 113 T.C. at 81-82.

134. *See id* at 88.

135. *Id.* at 89.

136. *Id.* at 93.

137. *See id.*

138. *See* Rev. Rul. 98-15, 1998-1 C.B. 718. The enforceability of Revenue Rulings upon the IRS is contingent on the facts presented. A variation, such as a different type of joint venture, may lose its binding effect.

139. *See Redlands*, 113 T.C. at 47.

140. *See* Rev. Rul. 98-15, 1998-1 C.B. 718; *See also Redlands*, 113 T.C. at 47.

understanding of the importance of prosperity in the healthcare industry. "The growth of private and employer-provided health insurance and the introduction . . .of government programs such as Medicare and Medicaid altered the economics of the healthcare sector and transformed the American hospital."[141] To reflect this trend, the Service and the courts have allowed joint ventures between nonprofits and for-profits to form with few restrictions.[142] Revenue Ruling 98-15 and *Redlands* set the limitations on the government's willingness to allow a metamorphosis of the tax-exemption law in a traditionally charitable industry.[143]

It is true that a joint venture between a for-profit and nonprofit can be successful while the nonprofit maintains its exempt status. Revenue Ruling 98-15 provides a "safe harbor" in situation one.[144] The IRS will accept entities that arrange the venture with similar governance provisions to situation one.[145] However, the arrangements that do not appear to match this structure have no guarantees.

In reality, the whole-hospital ventures have been structured as a cross between these two examples. Thus, the format of the currently issued guidance provides little assistance to entities contemplating a joint venture. "'[T]he good example and the bad example are so far apart that it leaves most of the real world deals somewhere in between.'"[146] For example, most joint ventures of this type use a management company connected with a for-profit entity, as seen in situation two.[147] "It is the expertise and success record of the for-profit companies that is being sought in these ventures."[148] In addition, the requirement that the nonprofit's members be a majority of the board of directors is unrealistic. Current transactions typically have equal representation or require a

141. FISHMAN & SCHWARTZ, *supra* note 15, at 384.

142. The Service maintained that net revenue joint ventures were private inurement per se and thus prohibited tax-exempt organizations from participating.

143. *See* Rev. Rul. 98-15, 1998-1 C.B. 718; *see generally Redlands*, 113 T.C. at 47.

144. *See* Rev. Rul. 98-15, C.B. 1998-1.

145. Revenue Rulings bind the IRS to the position that it takes in the revenue provided that the facts are mirror images.

146. Barbara Yuill, *Healthcare: Unwind Of Columbia Joint Venture in Virginia a First But Likely Not the Last, Experts Say,* DAILY TAX REPORT, Feb. 12, 1999, at J-2.

147. *See* HYATT & HOPKINS, *supra* note 77 , at 109.

148. *Id.*

supermajority vote. In either case, the tax-exempt owner, with only a standard majority, lacks the power to control the board as is recommended by the provisions of Revenue Ruling 98-15.[149]

This lack of certainty has already had an impact in the business world. A whole-hospital joint venture between Columbia/HCA Healthcare Corporation, a for-profit entity, and the Arlington Healthcare Systems, a nonprofit, was cancelled because the IRS failed to issue an approval of the transaction.[150] While approximately twenty-four whole-hospital joint ventures are in existence, half involve Columbia as the for-profit investor;[151] presumably, many take a similar form to the Arlington joint venture. Given the level of scrutiny proclaimed in Revenue Ruling 98-15, many ventures will not survive the fact-and-circumstance analysis, which must be extremely favorable to the nonprofit entities.[152] While the issuance of the ruling was a gesture of guidance,[153] the only direction actually provided was a "golden ticket"[154] hidden in a set of unascertainable facts.

If the recent litigation is supposed to help exempt organizations, there will be much disappointment. In *Redlands*, the Tax Court, with an affirmation on appeal, allied with the IRS as it examined a nonprofit's ability to maintain effective control over its operations.[155] The court did not take as strict a position as the Service, choosing instead to look at the totality of the circumstances, thus allowing more room for joint ventures to take place.[156] Nonetheless, an organization must again attempt to weigh the specific factors[157] the court addresses with no real understanding as to the characteristics needed to satisfy the requirements of § 501(c)(3).

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149. *See id.*

150. *See* Yuill, *supra* note 146, at J-1.

151. *See id.*

152. *See id.*

153. *See* HYATT & HOPKINS, *supra* note 77, at 110.

154. *See* Willy Wonka and the Chocolate Factory (Warner Bros. Family Entertainment 1971). A famous candymaker, Willie Wonka, randomly hides five golden tickets in candy bars. If a child finds a golden ticket wrapped around the candy bar he purchased, he wins a tour of Wonka's candy factory and the possibility of inheriting his candy fortune.

155. *See* Redlands Surgical Services v. Commissioner, 113 T.C. 47, 92 (1999).

156. *See id.* at 92-93 (finding that effective control could be reached without voting control; however, the totality of circumstances must be examined).

157. *See* discussion *infra* Section III, Part B.

The reasoning behind the agreements between both for-profit and nonprofit organizations allows each entity the most effective way to meet their financial needs. As suggested by the number of requests for private letter rulings regarding joint ventures from the IRS indicates that parties believe this type of arrangement will be beneficial to both sides.[158] Unfortunately, a failure in attempting to form a joint venture can further add stress to the financial burden already experienced by nonprofits. Millions of dollars are invested in creating the joint venture, which ultimately may be thrown away because of an adverse decision by the IRS or the courts.[159] In light of Revenue Ruling 98-15 and *Redlands* , the attractiveness of the arrangement has diminished.[160] The nonprofit will have a difficult time finding a for-profit entity that is willing to surrender control of the venture without receiving compensation for its sacrifice. Purchasing the control needed under the current analysis will greatly reduce the financial rewards the nonprofit was seeking to reap.[161]

Through both Revenue Ruling 98-15 and *Redlands*, nonprofit entities have a clear understanding of what not to do.[162] The borders outlining what will constitute an appropriate activity under the tax-exempt provisions have been established, and it is clear that certain agreements will lie outside those borders. However, by not providing a more detailed location of that perimeter, healthcare entities are forced to blindly choose to be in or out. As a result, some joint ventures will not be formed, some nonprofit entities will convert to for-profit entities, and some § 501(c)(3) organizations will lose their exempt status. By not taking a clear position, the IRS and the courts have indicated that tax-exemption is a reward for those who work to clearly add a benefit to the community. With understanding that healthcare entities need to be operated effectively and efficiently, thus requiring additional resources, private investors may be able to save the nonprofit healthcare organizations. However, it cannot be done at the expense of their tax-exemption status.

158. *See* Yuill, *supra* note 146, at J-2.

159. *See id.*

160. *See* Rev. Rul. 98-15, 1998-1 C.B. 718; *See also Redlands*, 113 T.C. at 47.

161. *See* Yuill, *supra* note 146, J-2.

162. *See* Rev. Rul. 98-15, 1998-1 C.B. 718; *See Redlands*, 113 T.C. at 47.